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Constructive Fraudulent Transfers—Determining Insolvency

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Introduction

When a debtor files for bankruptcy, all of the debtor's assets and liabilities are automatically transferred into a bankruptcy estate.¹ These assets are then used either to help a debtor reorganize or to repay all of the debtor's creditors in liquidation. Under the United States Bankruptcy Code (the "Bankruptcy Code"), to preserve the estate assets a bankruptcy trustee can avoid certain transfers made by debtors as fraudulent transfers.² Without this power to avoid transactions that occur prior to a debtor filing for bankruptcy, debtors could engage in transactions that drain the company of any of its valuable assets and leave little to no value for creditors.³

There are two types of fraudulent transfers recognized under the Bankruptcy Code – actual fraudulent transfers, and constructive fraudulent transfers.⁴ A bankruptcy trustee can avoid actual fraudulent transfers if the transfers were made with an actual intent to delay, hinder, or

¹ 11 U.S.C. § 541(a) (2012).

² *Id.* § 548; *see also* ASARCO LLC v. Americas Mining Corp., 396 B.R. 278, 315 (S.D. Tex. 2008) (stating that a bankruptcy trustee or a debtor in possession may pursue fraudulent conveyance claims during the pendency of a bankruptcy case).

³ *See* Citizens State Bank Norwood Young America v. Brown, 849 N.W.2d 55, 60 (Minn. 2014) (stating that fraudulent transfer laws are intended to prevent debtors from placing property that is otherwise available for the payment of their debts out of the reach of their creditors).

⁴ 11 U.S.C. § 548(a)(1)(A–B).

defraud creditors.⁵ A bankruptcy trustee can avoid constructive fraudulent transfers if the debtor: (1) received less than equivalent value in exchange for the transfer; and (2) the debtor was insolvent at the time that the transfer was made or became insolvent as a result of the transfer, the transfer left the debtor with unreasonably small capital, or the debtor intended to incur debts beyond its ability to pay.⁶

This memorandum focuses on constructive fraudulent transfers by reviewing the tests that bankruptcy courts apply to determine whether a debtor was insolvent. Part A discusses the balance sheet test, Part B examines the capital adequacy test and Part C addresses the cash flow test.

I. Determining Insolvency

Fraudulent conveyance laws require the transaction at issue to occur when, or result in, a debtor becoming insolvent.⁷ Insolvency is defined as a “financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation.”⁸ What is deemed to be a “fair valuation” is a highly fact specific inquiry that typically requires expert testimony.⁹ Thus, insolvency is an often-litigated issue.¹⁰

⁵ *Id.* § 548(a)(1)(A).

⁶ *Id.* § 548(a)(1)(B).

⁷ *Id.* § 548(a)(1)(B)(ii); *see also* Coated Sales, Inc. v. First Eastern Bank, 144 B.R. 663, 668 (S.D.N.Y. 1992) (explaining that the insolvency determination is based on the date on which the transfer at issue occurred).

⁸ 11 U.S.C. 101(32) (2012).

⁹ *See In re Robin Indus., Inc.*, 78 F.3d 30, 38 (2d. Cir. 1996) (“Whenever possible, a determination of insolvency should be based on season appraisals of expert testimony.”); *see also In re Idirium Operating LLC*, 373 B.R. 283, 350 (Bankr. S.D.N.Y. 2007) (“[A] court should exclude expert valuation testimony if the expert bases his analysis on an inappropriate set of cash flow projections, did not consider market values, and cannot explain the unreasonable implications of his analysis.”).

¹⁰ *See TeleFest, Inc. v. VU-TV, Inc.*, 591 F.Supp. 1368, 1376 (D.N.J.1984) (stating that insolvency is a question of fact that cannot lightly be taken from the jury).

Today, parties enter into complex transactions, which can make it difficult for judges to determine the proper test to use to determine insolvency.¹¹ To determine whether a debtor is insolvent, bankruptcy judges therefore apply several different tests, including the balance sheet test, the capital adequacy test, and the cash flow test.¹²

A. The Balance Sheet Test

A court may determine that a debtor is insolvent by using “the traditional bankruptcy balance sheet test of insolvency.”¹³ Under the balance sheet test, a debtor is “insolvent if its debts are greater than its assets, at a fair valuation.”¹⁴ Courts applying the balance sheet test must determine the fair market value of the debtor’s assets.¹⁵ Although balance sheets reflect the book value of a debtor’s assets, book value is not ordinarily an accurate reflection of the market value of an asset.¹⁶ Additionally, balance sheets often contain assets like goodwill, patents, or trademarks within their bottom line that are of little to no value to any third-parties. Thus, courts must exclude these items from its fair market value analysis.¹⁷

Furthermore, insolvency must be determined as of the date on which the transfer at issue occurred.¹⁸ However, balance sheets are done at month or year end and cover the beginning and

¹¹ See, e.g., *Prod. Res. Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 790 n.57 (Del. Ch. 2004) (“When a firm is insolvent or near insolvency, the interests of its stockholders and creditors can be starkly divergent, with the stockholders preferring highly risky strategies that creditors would eschew.”).

¹² See *Paloian v. LaSalle Bank*, 619 F.3d 688, 693 (7th Cir. 2010) (presenting expert testimony from accountants who used several different methods to calculate insolvency); see also *Calfarm Ins. Co. v. Deukmejian*, 48 Cal.3d 805, 818 (Cal. 1989) (“Insolvency has various meanings[.]”).

¹³ *In re WRT Energy Corp.*, 282 B.R. 343, 368 (Bankr. La. 2001); see also *In re Kallmeyer*, 242 B.R. 492, 496–97 (B.A.P. 9th Cir. 1999) (affirming a bankruptcy court’s use of the balance sheet test to determine insolvency).

¹⁴ *In re Pioneer Home Builders, Inc.*, 147 B.R. 889, 891 n.3 (Bankr. W.D. Tex. 1992); see also *Universal Church v. Geltzer*, 463 F.3d 218, 226 (2d. Cir. 2006) (stating that insolvency is determined by the balance sheet test, under which the debtor is insolvent if the debtor’s assets exceed its liabilities at the time of the transfer).

¹⁵ See *Briden v. Foley*, 776 F.2d 379, 382 (1st Cir.1985) (“Th[e] balance sheet test focuses on the fair market value of the debtor’s assets and liabilities within a reasonable time of the transfers.”).

¹⁶ See *Quadrant Structured Prod. Co., Ltd. v. Vertin*, 115 A.3d 535, 560 n.31 (Del. Ch. 2015) (explaining that the balance sheet test is based on a fair valuation and not based on GAAP, which are typically used to prepare a balance sheet).

¹⁷ See, e.g., *U.S. v. Winstar Corp.*, 518 U.S. 839, 854 (1996) (explaining that goodwill is simply valueless in the context of liquidation).

¹⁸ *Coated Sales*, 144 B.R. at 668.

end of a set period. Within the period covered by a particular balance sheet, a debtor may go from solvent to insolvent many times, making it difficult to determine whether the debtor was truly insolvent or rendered insolvent at the time of the transfer at issue. Similarly, a party may not rely on values assigned to certain assets at earlier and/or later parts of a case, as valuation determinations have no precedential value for other times and issues within a particular case.¹⁹ For example, a creditor seeking protection from insolvency cannot argue that a specific value of an asset at a particular time can be used to accurately estimate its value at a later time.²⁰

B. Capital Adequacy Test

Some bankruptcy courts apply the capital adequacy test to determine insolvency. The capital adequacy test examines whether the transfer at issue left the debtor with unreasonably small capital for the operation of its business.²¹ This is a fact-intensive analysis that is not typically subject to summary judgement.²² To determine the amount of capital required to continue business operations, courts will consider many factors, including the type of business, the risks faced by the business, and whether the business was adequately capitalized.

Courts using the capital adequacy test must base their determination on whether it was reasonably foreseeable to the debtor that the transfer at issue, at the time it was made, would leave the debtor with unreasonably small capital.²³ This is because courts are reluctant to apply improper hindsight bias.²⁴

¹⁹ S. Rep. No. 95-589, 54 (1979).

²⁰ See *Credit Managers Ass'n v. Federal Co.*, 629 F.Supp. 175 (C.D. Cal. 1985).

²¹ 11 U.S.C. § 548(a)(1)(B)(ii)(II); see also *Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1070 (3d Cir. 1992) (explaining the capital adequacy test as whether the transfer at issue left the debtor with an inability to generate sufficient profits to sustain operations); see also *In re Joy Recovery Tech. Corp.*, 286 B.R. 54, 76 (Bankr. Ill. 2002) (stating that courts consider whether the transfer put the debtor on the road to ruin).

²² *Mukamal*, 588 B.R. at 643.

²³ *In re Semcrude, L.P.*, 526 B.R. 556, 560 (Del. 2014).

²⁴ See *Mukamal*, 588 B.R. at 640 (declining to attribute current facts to the valuation of certain finance receivables because it would be an example of an inappropriate use of hindsight in valuing assets); see also *LaSalle Bank*, 619

While courts using the capital adequacy test are reluctant to apply improper hindsight bias, some courts have allowed the use of retrojection in cases where a debtor's financial position is unascertainable on the date of the challenged transfer. Retrojection allows a bankruptcy trustee to show a debtor's insolvency by "using company books and a later inventory and by working backwards[.]" allowing insolvency to be inferred absent a radical change in assets or liabilities between the retrojection dates.²⁵ Thus, the debtor's insolvency is shown by using company books and other financial records, and by working backwards after the critical date, thereby proving other facts from which the ultimate fact of insolvency on the transfer dates may be inferred or presumed.²⁶

C. Cash Flow Test

Bankruptcy courts may also apply the cash flow test, which determines whether the debtor intended or expected to incur debts beyond its ability to pay.²⁷ The capital adequacy test is often referred to as equitable insolvency.²⁸ Courts applying the cash flow test will use a reasonable person standard to determine whether the debtor intended or expected to incur debts

F.3d at 693 (stating that although hindsight is wonderfully clear, to determine solvency in mid-1997 it is necessary to determine the expected value of this liability as of mid-1997, not the actual value as of 1999 or 2000).

²⁵ Haynes & Hubbard, Inc., v. Stewart, 387 F.2d 906, 907 n.1 (5th Cir. 1967); *see also* State ex rel. Wagner v. Gilbane Bldg. Co., 280 Neb. 223, 234 (Neb. 2010) (allowing a financial expert to use retrojection to determine that the debtor was insolvent between June 2000 and June 2001).

²⁶ *See* Inland sec. Co., Inc. v. Kirshner's Estate, 382 F.Supp 338, 345 (Mo. 1974) (reasoning that in many instances it is difficult to prove insolvency on a given date prior to bankruptcy and the determination of insolvency may not be susceptible to precise proof).

²⁷ 11 U.S.C. § 548(a)(1)(B)(ii)(III); *see also* *In re* Opus East, LLC, 528 B.R. 30, 51 (Bankr. Del. 2015) ("Insolvency is proven under the cash flow test if at the time of a transfer, the debtor intended to incur or believed that it would incur debts beyond its ability to pay as such debts matured.").

²⁸ *See* *Moody*, 971 F.2d at 1064 (explaining insolvency in the equity sense as an inability to pay debts as they mature).

beyond its ability to pay.²⁹ If the debtor is able to continue conducting business on a going basis, they will usually be considered cash flow solvent.³⁰

Conclusion

Determining whether a debtor is insolvent or rendered insolvent by a constructive fraudulent transfer requires a fact specific analysis. Bankruptcy courts, depending on the circumstances of a case, apply various tests to determine whether a debtor was insolvent. The conventional balance sheet test is often used. This test requires bankruptcy courts to adjust the balance sheet's book value to reflect fair market value, to exclude certain assets that are of little value to third parties, and to determine insolvency on a certain date by using a balance sheet that was made to reflect a larger period of time. The capital adequacy test is a highly fact-specific test, and thus requires that bankruptcy courts be careful to make the determination based on what was reasonably foreseeable to the debtor at the time the transfer was made, and not to apply inappropriate hindsight bias. The cash flow test is another highly fact-specific test, but this test requires the use of a reasonable-person standard. Accordingly, depending on the circumstances of the case, there are various tests a bankruptcy court can utilize in determining whether a debtor was insolvent or rendered insolvent by a constructive fraudulent transfer.

²⁹ See *CB Richard Ellis, Inc. v. CLGP, LLC*, 251 P.3d 523, 531 (Colo. App. 2010) (“[S]aying that the reserve was reasonable is a shorthand way of saying the LLC retained sufficient capital . . . and never intended to render itself insolvent.”).

³⁰ See *Whitley v. Carolina Clinic, Inc.*, 455 S.E.2d 896, 900 (N.C. Ct. App. 1995) (finding a corporation solvent because it was able to meet its obligations and continue to do business).